1031 Exchanges: FIRPTA Made Simple

This document is interactive, please utilize the hyperlinks below which will redirect you to specific IRS.gov webpages for guidance. This article is strictly informational. For inquiries regarding the same, please contact the Internal Revenue Service directly.

The Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") income tax withholding has become more commonplace as a significant amount of real property in the United States is owned by foreign investors. Due to the sheer volume of U.S. foreign-owned property, the Internal Revenue Service (IRS) implemented a 15% tax withholding to reduce the risk of "foreign persons" avoiding payment of the capital gains tax normally due on their sales. "Foreign persons" are subject to FIRPTA unless particular exemptions are met. *See* 26 U.S. Code §1445 - Withholding of tax on dispositions of United States real property interests.

FIRPTA applies to all "foreign persons." The IRS defines the same as including "non-resident alien individuals," foreign corporations, foreign partnerships, foreign trusts and estates, and any other person that is not a U.S. person.[1] A "non-resident alien" is any non-U.S. citizen who either does not pass the Green Card Test or the Substantial Presence Test. Equally, FIRPTA does not apply to "U.S. Persons"; the same is defined by the IRS as a citizen or *resident* of the United States, a domestic partnership, a domestic corporation, any estate other than a foreign estate, and any other person that is not a foreign person.[2] To determine if you fall under the categories listed above, visit the IRS website here.

What Is FIRPTA?

For United States property dispositions subject to FIRPTA, the **buyer** is required to withhold and remit to the IRS fifteen (15%) percent of the aggregate sales price if the seller is a foreign person. As stated on the IRS website, for most non-resident sellers the general rule requires withholding 15% of the value. If the foreign seller is a corporation or a trust, the withholding amount increases to 21%.

The buyer is required to send the withholding directly to the IRS within 20 days of the close of the transaction to ensure any taxable gain realized by the foreign seller is paid (unless a Withholding Certificate has been applied for; discussed further below). The withholding rate is computed differently for other foreign entities, such as foreign corporations and trusts.

Always be sure to consult with your tax and/or legal advisor to confirm which withholding rate is applicable to you.

How Does This Impact My 1031 Exchange?

Under IRC Section 1031, a foreign investor may exchange their "like-kind" U.S. real property interest while still reaping the benefits of 1031 tax deferral; however, the FIRPTA withholdings do create additional complications.

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[1] https://www.irs.gov/individuals/international-taxpayers/classification-of-taxpayers-for-us-tax-purposes#:~:text=a%20foreign%20person.-,Foreign%20Persons,-A%20foreign%20person

[2] https://www.irs.gov/individuals/international-taxpayers/classification-of-taxpayers-for-us-tax-purposes#:~:text=types%20of%20taxpayers.-,United%20States%20Persons,-The%20term%20%27%27United

Generally, when funds are withheld from a 1031 Exchange, those funds are considered "boot." "Boot" refers to non-like kind property received in an exchange (funds not reinvested in real estate) and is subject to capital gains tax. If, for example, 15% of funds are withheld due to FIRPTA, **those funds cannot be reinvested and are therefore considered fully taxable "boot."** It is important to understand that FIRPTA withholding is not necessarily a tax itself, but an estimated tax used to efficiently collect from "foreign persons." In a 1031 exchange, the amount withheld for FIRPTA is an estimated capital gain liability which otherwise would not occur if the sale proceeds were fully invested in like-kind property. Therefore, withholding any amount from a 1031 exchange is problematic, even if the funds withheld are later refunded.

To avoid the above, there are a handful of strategies that a taxpayer may use to reduce or eliminate the FIRPTA withholding requirements:

1. **SET ASIDE ADDITIONAL FUNDS**
    - "Additional funds" refers to personal, out of pocket funds; those which are outside and unrelated to the exchange.
    - Setting aside additional funds to cover the FIRPTA withholding will allow the total amount of your proceeds to be reinvested, thereby avoiding capital gains taxes. Upon filing tax returns for that tax year, any extra that was withheld would be returned if you no tax liability is incurred.
2. **PERFORM A SIMULTANEOUS (SAME DAY) EXCHANGE WITH *NO BOOT***
    - A *simultaneous* exchange is when a taxpayer closes on the sale and purchase of "like-kind" property on the same day. If all 1031 exchange requirements are met (must be a complete deferral), the foreign investor may qualify. To ensure that the buyer does not withhold funds, the foreign seller must file a *Declaration and Notice to Complete an Exchange* (1031 Declaration and Notice) which puts the buyer on notice that no withholding will be required.
3. **REQUEST A WITHHOLDING CERTIFICATE FROM THE IRS**
    - *26 CFR §1445-3(b)(6)*: By requesting a Withholding Certificate (IRS Form 8288-B) from the IRS, a foreign investor can receive permission from the IRS to prevent FIRPTA withholding on their sale. **If a Withholding Certificate is not received prior to the purchase of the replacement property, the funds will be withheld, and the Exchanger will not have access to them.** The approval process could take over ninety (90) days, so it is critical that the foreign investor consult with their tax or legal advisor to avoid missing any of the critical 1031 exchange deadlines.
        - If funds are released within the exchange period, the escrow agreement should specify that funds are to be sent directly to the QI to mitigate any constructive receipt exposure.
            - "Use Form 8288-B, Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests to apply for a withholding certificate under categories (1), (2), and (3). See Withholding Certificates Related to U.S. Real Property Interest and Publication 515, Withholding of Tax on Nonresident Aliens and Foreign Entities, for detailed instructions on how to apply for a withholding certificate under each of these categories. Do not use Form 8288-B for applications under categories (4), (5), and (6). For these categories, follow the instructions given here. [emphasis added]"[3]

[3] https://www.irs.gov/individuals/international-taxpayers/format-for-applications

4. **REAL ESTATE PURCHASED AS A RESIDENCE**
   - *26 CFR §1445-2(d)(1)*: "No withholding is required under section 1445(a) if one or more individual transferees acquire a U.S. real property interest for use as a residence and the amount realized on the transaction is $300,000 or less." For specifics related to what constitutes a "residence" and additional requirements, please refer to 26 CFR §1445-2(d)(1).

The Seven (7) FIRPTA Steps in a 1031 Exchange:

The below steps are informational; they are not to be construed as legal or tax advice and should only be utilized to facilitate a discussion between the taxpayer and their legal or tax advisors.

Step 1: Confirm that the property being sold is a U.S. real property interest. Consult with your CPA/tax advisor to determine if FIRPTA applies to you and determine if you are a "Foreign Person" under the regulations. Both required to proceed.

Step 2: Review FIRPTA exceptions to determine if an exception to withholding applies to your transaction.

Step 3: Obtain a TIN (Taxpayer Identification Number). If you are a "Foreign Person," then you must obtain a U.S. TIN.

i. Individuals: File IRS Form W-7, Application for IRS Individual Identification Number.

ii. Businesses: File IRS Form SS-4, Application for Employer Identification Number.

Step 4: Withholding Certificate. Next, you must apply for a Withholding Certificate.

i. Details can be found on the IRS website, here.

Step 5: Notify your buyer of your FIRPTA obligations / that you have applied for a Withholding Certificate.

Step 6: Prior to closing, contact your Qualified Intermediary (QI). Once engaged, your QI will prepare your exchange documents, open your file, etc. Documents will subsequently be forwarded to your closing agent.

Step 7: Your exchange clock starts when the property closes. The buyer must file the applicable IRS Forms (generally Form 8288 and 8288-A[4]) to report and pay the amount withheld to the IRS by the 20th day after the date of the relinquished property closing.

When FIRPTA is applicable, additional steps must be taken to ensure that the exchange is structured accordingly, and the appropriate taxes are withheld. It is highly recommended that the foreign investor consult with their tax or legal advisor regarding the implications and conditions of the same.

If a foreign exchanger elects to take advantage of a 1031 exchange, they must provide their qualified intermediary with IRS Form W8-BEN (form instructions here) which provides the qualified intermediary with the exchanger's Individual Tax Identification Number (ITIN). An ITIN can be applied for with IRS Form W-7 (form instructions here). Exchange funds will not be released on behalf of any foreign investor who does not provide Legal 1031 with their ITIN.

[4] These IRS forms can be found here: Form 8288-A; Form 8288. Always check with your tax or legal advisors to ensure that any linked forms are the most updated and applicable to your exchange.